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C O N F I D E N T I A L SECTION 01 OF 02 MOSCOW 000322

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TAGS: EPET ENRG ECON EFIN PREL RS
SUBJECT: SHIFTING EAST SIBERIAN OIL TAX HOLIDAYS REVEAL
PROBLEMATIC TAX REGIME

Classified By: EconMinCouns Matthias J. Mitman, Reasons 1.4 (b,d)

SUMMARY

¶1. (C) Starting in 2010, the GOR instituted a new export tax exemption for certain East Siberian oil fields in order to stimulate hydrocarbon development in the region. DPM Sechin supports the exemption to encourage shipments of oil east through the new East Siberia-Pacific Ocean (ESPO) pipeline. The exemption has also sparked conflict between Sechin and fellow DPM and Minister of Finance Kudrin, who prefers the GOR maintain the export tax and its revenues. A compromise called for the exemption to end March 1 and created a GOR working group to determine the future of the exemption. Industry analysts and company executives argue that even this exemption is not enough, and that Russia needs deeper reform to its tax regime in order to attract investment in oil production from new fields. The current system of temporary tax breaks is unsustainable and likely will not provide the confidence needed to secure needed long-term investment. End Summary.

GOR EXEMPTS EAST SIBERIA FROM OIL EXPORT TAX

¶2. (U) In July 2009, the GOR issued a decree exempting 13 oil fields in East Siberia, including state-owned Rosneft's giant new Vankor field, from the oil export tax in order to encourage the development of fields in the region. (Note: At USD 70 per barrel, oil companies would pay approximately USD 34 per barrel in export taxes without the exemption. End Note) In December, the list expanded to include 22 fields. Among major oil companies operating in Russia, Rosneft, Surgutneftegaz, and TNK-BP would benefit most from the exemption.

¶3. (U) However, complications stemming from the creation of Russia's customs union with Belarus and Kazakhstan delayed implementation of the exemption. Under the rules of the new customs union, which took effect on January 1, oil from the exempted fields received a new tariff code, and the number of fields covered increased to 22. However, the government decree establishing the exemption used the old tariff code, which was in force when only 13 fields qualified. The Federal Customs Service corrected the order so that the exemption would extend to all 22 East Siberian fields as of

January 19.

GOR POSTURING OVER EXTENT OF THE EXEMPTION

¶4. (U) Although expanded to cover 22 fields, the exemption may only benefit exports to the east. In January, DPM Igor Sechin, who is in charge of the energy sector, requested that the Ministry of Energy review the possibility of restricting the exemption so that it would only apply to oil shipped east through the East Siberia-Pacific Ocean (ESPO) pipeline. If enacted, the new regulation would force Rosneft to deliver all crude from the Vankor field east via the ESPO pipeline. At present, oil from the field travels west for export, primarily from the port of Novorossisk. In 2009, Rosneft commissioned a 0.28 million bpd pipeline to facilitate shipments through ESPO, which it plans to expand by 2015 when Vankor's output should spike to 0.5 million bpd.

¶5. (SBU) The East Siberia tax exemption has also sparked conflict between GOR energy and finance officials. Sechin and Minister of Energy Sergey Shmatko support the initiative. In October 2009, Shmatko announced that the exemption could be extended for up to 5-7 years. On the other hand, DPM and Minister of Finance Alexey Kudrin claims the exemption is economically unjustified and could cost the GOR RUR 120 billion (USD 4 billion) in revenue in 2010. At a January meeting, the two sides agreed to a compromise option under which the exemption will extend only until March 1. A special working group will assess the situation and propose

ways to compensate the GOR for lost revenue. One option reportedly being considered is to reintroduce the tax for East Siberia, but at a discounted rate. According to press reports, the working group may release its recommendations as early as February 15.

¶6. (SBU) Investment analysts' predictions about the outcome vary widely. Deutsche Bank's February 12 note on the matter suggests the tax holiday will disappear. Investment bank Troika's note predicts it will continue for "at least three years." UBS suggests the working group will recommend continuing the tax breaks, with the lost revenues to be compensated by an increase in the gas production tax. Such a tax would put the $4 billion burden largely on state-owned Gazprom.

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FICKLE MEASURES INADEQUATE TO STIMULATE INVESTMENT
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¶7. (C) During a February 9 meeting, Alexander Burgansky, Head of Equity Research for Renaissance Capital, told us that while the exemption could remain after the compromise period ends, it was unlikely to last beyond the end of 2010. Burgansky also stated that oil companies lack the proper incentives to invest in East Siberia, even with the exemption, because the GOR's special tax breaks are unsustainable. He emphasized the fact that the Russian oil sector had the potential to continue increasing its production, but only given the right incentives.

¶8. (SBU) According to a 2009 Lukoil poll, export tax reduction and reforms to the mineral extraction tax (MET) are oil company managers' top priorities for regulatory reform. Thirty percent of those polled expressed the strongest desire to see a reduction in the export tax. Eighteen percent want differentiation of the MET depending on the geological complexity of the field and an increase in the non-taxable MET base. (Note: In 2009, the GOR did increase the non-taxable MET base from USD 9 to USD 15 per barrel. End Note) Other key demands included accelerated amortization, VAT reduction, and tax consolidation. Many executives have told us they would prefer that the GOR shift away from

revenue- and production-based taxes to a simpler tax based on profits.

COMMENT

¶9. (C) The GOR's oil sector tax regime appears designed to maximize short-term government revenues and fulfill domestic and international objectives unrelated to oil sector productivity. Major oil companies that are deciding whether to risk billions of dollars in a new field are looking at both the potential rate of return of the project and the stability of the fiscal and regulatory regime over twenty or more years. A tax structure that siphons away up to 90% of revenues above $25 per barrel leaves little for new upstream investments and reduces the upside potential for investors. Furthermore, temporary holidays and other tax breaks that depend on shifting political objectives and fiscal priorities do not provide oil companies the confidence they need to make the multi-billion dollar long-term investments needed to fully exploit Russia's vast hydrocarbon potential. End Comment.
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